VZCZCXRO5047
PP RUEHGA RUEHHA RUEHMT RUEHQU RUEHVC
DE RUEHOT #0070/01 0261307
ZNR UUUUU ZZH
P 261307Z JAN 09
FM AMEMBASSY OTTAWA
TO RUEHC/SECSTATE WASHDC PRIORITY 9019
INFO RHEHAAA/WHITE HOUSE WASHDC
RUEAIIA/CIA WASHDC
RHEHNSC/NSC WASHDC
RUCPDOC/USDOC WASHDC
RUEATRS/DEPT OF TREASURY WASHDC
RUEHME/AMEMBASSY MEXICO 1915
RUCNCAN/ALL CANADIAN POSTS COLLECTIVE

UNCLAS SECTION 01 OF 04 OTTAWA 000070

SENSITIVE

SIPDIS

STATE FOR E, EB/DCT, WHA/EX, WHA/CAN

STATE PASS USTR (SULLIVAN)

COMMERCE FOR ITA/MAC (WORD)

TREASURY FOR IA (NEPHEW)

E.O. 12958: N/A
TAGS: ECON EFIN ETRD EINV EIND PREL PGOV CA
SUBJECT: Canada's Coming Federal Budget and Stimulus Prospects

REF: A. 08 OTTAWA 1574
¶B. 08 OTTAWA 1516 (AND PREVIOUS)
¶C. 08 OTTAWA 1372
¶D. 08 OTTAWA 1528
¶E. TORONTO 20
¶F. 08 TORONTO 204 (AND PREVIOUS)

SENSTIVE BUT UNCLASSIFIED. PLEASE PROTECT ACCORDINGLY

¶1. (SBU) Summary: With the economy dominating the political landscape (ref a), Canada's opposition parties have made the January 27 federal budget a litmus test of PM Harper's ability to make his Conservative minority government work. Ottawa observers estimate that the budget will pass with just enough grudging support - or abstentions - by the Liberals. Budget details remain hidden behind Canadian secrecy rules until January 27, but the expected legislation is the product of cross-country and cross-constituent brokerage. The budget will likely contain considerable infrastructure spending, tax cuts and credits aimed at the middle class and industry, and a range of social spending initiatives. Monetary stimulus - a combination of rate cuts and liquidity injections - has been ongoing since November and the Bank of Canada reports that there is room for additional monetary stimulus. End Summary

Economic and Political Context

¶2. (SBU) Canada entered the world financial crisis with strong economic fundamentals - including low unemployment, eleven years of budget surpluses, record prices for commodities, and a well-regulated banking sector. Despite these strengths, Canada's medium-sized, open economy has little influence on the global stage and is vulnerable to external forces. For example, exports to the United States are critical to Canadian GDP, so falling U.S. demand has had a quick and negative effect on the Canadian economy. Given Canada's size and outward orientation, government stimulus packages can do relatively little to promote recovery, other than make competitiveness improvements at the margins and buy time until export demand returns.

¶3. (SBU) The confluence of the global financial crisis and a domestic parliamentary crisis (ref b) have made federal spending debates more volatile than usual (ref d). On December 4, Prime

Minister Harper prevailed upon the Governor General to suspend Parliament, which avoided the defeat of his minority government in the House of Commons. While other factors played a role, much of the parliamentary crisis was blamed on the government's overly optimistic assessment of the Canadian economy and lackluster proposals for stimulus and recovery. This provoked criticism that the government was not doing enough to help Canadians deal with domestic and global economic turmoil.

¶4. (SBU) The January 27 presentation of the FY 2009 budget provides the Conservative government with an opportunity to make amends on economic stimulus and to re-exert political leadership. PM Harper has announced that his budget will contain significant spending that will "sustain economic activity and confidence in Canada," even if this means that Canada will once again take on a deficit that the government admitted (likely to pre-empt criticism next week) on January 23 will run as high as C$34 billion for 2009 and C$30 billion for 2010. This will push Canada's debt to GDP ratio from 23.4 percent in 2007 - the lowest among the G7 countries - to 28 Q23.4 percent in 2007 - the lowest among the G7 countries - to 28 percent. (Comment: Since 1998, running a federal deficit has been anathema to Canada's political parties --ref c. End comment) On January 22, the Bank of Canada separately predicted that Canada would recover from its recession in less than year, with GDP shrinking by 1.2 percent in 2009 and growing by 3.8 percent in ¶2010.

¶5. (SBU) The government stimulus package is expected to total between C$20 and C$30 billion and to include a combination of tax cuts, infrastructure spending, and assistance for those groups and sectors hardest hit by the financial crisis (the last a key demand of the opposition Liberal Party). Distributional decisions about

the stimulus could present problems because Canada's constitution divides federal and provincial responsibility for economic issues. Public federal funds are allocated to the provinces through transfer payments and also through direct provision of services by federal agencies in such areas as industry, natural resources, and the environment.

Federal Assistance to the Provinces

¶6. (SBU) To preserve the stability of federal-provincial relations, Ottawa seeks to treat all provinces equally on issues such as infrastructure spending. Federal officials have been holding cross-country meetings with provincial representatives and business leaders to prepare the new budget. Infrastructure spending will have to be coordinated with provinces, as will particular types of sectoral assistance. At the same time, federal authorities must weigh the costs and benefits of assisting regionally concentrated industries, such as the auto sector (Ontario) and forestry (Quebec and British Columbia), where longer-term competitive prospects are uncertain. The federal government's early commitment to auto sector assistance (ref e) has fuelled sectoral requests from other regions. (A C$4 billion auto sector package was announced in December, with more than C$1 billion coming from Ontario province.) Since 2006, PM Harper has made significant monetary and political overtures to Quebec in a largely unsuccessful bid to bolster federalism and to build a new political base for the Conservatives in the province as a key to a future majority victory. There is speculation that the government's disappointing performance in Quebec in the October 2008 federal election might translate into less money for the province in the January 27 budget if the government seeks instead to consolidate support elsewhere, notably in Ontario.

Reaching out to the Opposition

¶7. (SBU) Since the December parliamentary crisis, PM Harper has made some uncharacteristic efforts to reach out to his political opponents, including the new leader of the official opposition, Liberal party head Michael Ignatieff. Liberal economic critics have also met at least once with their Conservative counterparts.

Ignatieff has publicly urged the government to focus on social spending, including more generous unemployment and re-training benefits and measures aimed at housing and infrastructure. All three opposition parties, however, have complained that the government's outreach and willingness to listen to their views have been too little. Meanwhile, the Prime Minister's center-right economic advisory panel has urged the government to avoid deep deficits -- anathema to many Canadian voters, not only on the Conservative side -- and to craft a limited stimulus package that focuses on Canada's longer-term competitiveness. Privy Council advisers told EMIN on January 23 that they were confident that the opposition would approve this budget, albeit with complaints.

Prospects for Stimulus Spending

¶8. (U) The government has indicated that its main budgetary focus will be infrastructure spending and relief for the middle class. Total government spending should fall close to the two percent of QTotal government spending should fall close to the two percent of GDP range endorsed by the IMF in January. For Canada, this represents some C$30 billion, although falling government revenues have prompted new spending estimates closer to C$20 billion.

¶9. (U) Infrastructure investment will likely include expanded and accelerated spending on highways, bridges, roads, sewer and water systems, public transit, and green energy. With a number of infrastructure projects already in train, the total planned spending on infrastructure now tops C$50 billion with approximately C$14 billion in expected new spending. However, federal cost-sharing proposals for infrastructure are drawing criticism from less-well-off provinces and municipalities, most notably at meetings of provincial and municipal leaders with PM Harper during the week

of January 12.

¶10. (SBU) The Canadian Council of Chief Executives and other economic think tanks have recommended corporate income tax cuts to encourage business investment, research and development, and increased competitiveness. These cuts might be helpful in countering deflationary pressures from the current recession. Tax credits to encourage consumer spending are also expected. If the government introduces broad social spending, it will likely want to proceed cautiously with tax measures to avoid - by Canadian standards - massive deficits.

¶11. (SBU) Stimulus to the manufacturing sector hangs on the question of which sectors have the capacity for long-term competitiveness once U.S. and global demand return. Canadian Conference Board Chief Economist Glen Hodgson has recommended that the government provide only minimal assistance to declining sectors and instead to facilitate orderly downsizing.

¶12. (U) Commodity exports- especially energy and agriculture - are expected to support the recovery of the Canadian economy as global prices begin to rebound. There are few budgetary proposals for stimulus in the commodities market except for continued calls for green investment in the energy sector. Also, Alberta has warned the federal government that the recent fall in oil prices will significantly reduce the more than C$16 billion that the province annually transfers to Ottawa.

Monetary Stimulus

¶13. (U) Interventions by the Bank of Canada and the government in monetary policy and the financial sector, respectively, have been ongoing since October. The Bank has cut its benchmark lending rate from three to one percent - and appears open to additional quantitative easing (government purchases of securities and debt). The government has already added more than C$100 billion in liquidity to Canadian banks and government lenders. The global crisis has served as a catalyst for other improvements in the financial sector, including a restructuring plan for non-bank

sponsored asset-backed commercial paper (ref f and septel) and progress toward the formation of a single national securities regulator.

¶14. (U) A lingering financial problem that the government may attempt to deal with in the budget is the shrinking secondary credit market. Over the past four months, consumers and businesses have found it increasingly difficult to lease vehicles and equipment. Among the proposals under consideration by the government are loans and guarantees for existing credit firms as well as regulatory changes to allow more players into the market (e.g., allowing chartered banks to offer auto leases). Canadian business associations have also urged the government to provide equipment loans directly to firms and to suspend tariffs on equipment imports.

Comment

¶15. (SBU) Despite Canada's solid economic fundamentals, the government's budgetary stimulus will only work on the margins until global demand recovers. Until then it must walk a fine line between delivering "enough" spending to cushion the recession and satisfy the opposition parties and reassuring its own Conservative base and hesitant voters that the return to deficit is necessary and temporary. While PM Harper has been largely unmoved by opposition
Qtemporary. While PM Harper has been largely unmoved by opposition
criticism in the past, Michael Ignatieff's promising start as Liberal leader and the lingering option of a Liberal-NDP coalition supported by the Bloc Quebecois appear to have led the Prime Minister to approach the new budget in a more conciliatory way than has been his norm, as well as to abandon a long-standing principle against deficit spending in the short-run. End comment.
BREESE